

## SECOND DIVISION

[G.R. No. 147950. December 11, 2003]

**CALIFORNIA BUS LINES, INC., *petitioner*, vs. STATE INVESTMENT HOUSE, INC.,  
*respondent*.****D E C I S I O N****QUISUMBING, J.:**

In this petition for review, California Bus Lines, Inc., assails the decision,<sup>[1]</sup> dated April 17, 2001, of the Court of Appeals in CA-G.R. CV No. 52667, reversing the judgment<sup>[2]</sup>, dated June 3, 1993, of the Regional Trial Court of Manila, Branch 13, in Civil Case No. 84-28505 entitled *State Investment House, Inc. v. California Bus Lines, Inc.*, for collection of a sum of money. The Court of Appeals held petitioner California Bus Lines, Inc., liable for the value of five promissory notes assigned to respondent State Investment House, Inc.

The facts, as culled from the records, are as follows:

Sometime in 1979, Delta Motors Corporation M.A.N. Division (Delta) applied for financial assistance from respondent State Investment House, Inc. (hereafter SIHI), a domestic corporation engaged in the business of quasi-banking. SIHI agreed to extend a credit line to Delta for P25,000,000.00 in three separate credit agreements dated May 11, June 19, and August 22, 1979.<sup>[3]</sup> On several occasions, Delta availed of the credit line by discounting with SIHI some of its receivables, which evidence actual sales of Delta's vehicles. Delta eventually became indebted to SIHI to the tune of P24,010,269.32.<sup>[4]</sup>

Meanwhile, from April 1979 to May 1980, petitioner California Bus Lines, Inc. (hereafter CBLI), purchased on installment basis 35 units of M.A.N. Diesel Buses and two (2) units of M.A.N. Diesel Conversion Engines from Delta. To secure the payment of the purchase price of the 35 buses, CBLI and its president, Mr. Dionisio O. Llamas, executed sixteen (16) promissory notes in favor of Delta on January 23 and April 25, 1980.<sup>[5]</sup> In each promissory note, CBLI promised to pay Delta or order, P2,314,000 payable in 60 monthly installments starting August 31, 1980, with interest at 14% per annum. CBLI further promised to pay the holder of the said notes 25% of the amount due on the same as attorneys fees and expenses of collection, whether actually incurred or not, in case of judicial proceedings to enforce collection. In addition to the notes, CBLI executed chattel mortgages over the 35 buses in Delta's favor.

When CBLI defaulted on all payments due, it entered into a restructuring agreement with Delta on October 7, 1981, to cover its overdue obligations under the promissory notes.<sup>[6]</sup> The restructuring agreement provided for a new schedule of payments of CBLI's past due installments, extending the period to pay, and stipulating daily remittance instead of the previously agreed monthly remittance of payments. In case of default, Delta would have the authority to take over the management and operations of CBLI until CBLI and/or its president, Mr. Dionisio Llamas, remitted and/or updated CBLI's past due account. CBLI and Delta also increased the interest rate to 16% p.a. and added a documentation fee of 2% p.a. and a 4% p.a. restructuring fee.

On December 23, 1981, Delta executed a Continuing Deed of Assignment of Receivables<sup>[7]</sup> in favor of SIHI as security for the payment of its obligations to SIHI per the credit agreements. In view of

Deltas failure to pay, the loan agreements were restructured under a Memorandum of Agreement dated March 31, 1982.<sup>[8]</sup> Delta obligated itself to pay a fixed monthly amortization of ₱400,000 to SIHI and to discount with SIHI ₱8,000,000 worth of receivables with the understanding that SIHI shall apply the proceeds against Deltas overdue accounts.

CBLI continued having trouble meeting its obligations to Delta. This prompted Delta to threaten CBLI with the enforcement of the management takeover clause. To pre-empt the take-over, CBLI filed on May 3, 1982, a complaint for injunction<sup>[9]</sup>, docketed as Civil Case No. 0023-P, with the Court of First Instance of Rizal, Pasay City, (now Regional Trial Court of Pasay City). In due time, Delta filed its amended answer with applications for the issuance of a writ of preliminary mandatory injunction to enforce the management takeover clause and a writ of preliminary attachment over the buses it sold to CBLI.<sup>[10]</sup> On December 27, 1982,<sup>[11]</sup> the trial court granted Deltas prayer for issuance of a writ of preliminary mandatory injunction and preliminary attachment on account of the fraudulent disposition by CBLI of its assets.

On September 15, 1983, pursuant to the Memorandum of Agreement, Delta executed a Deed of Sale<sup>[12]</sup> assigning to SIHI five (5) of the sixteen (16) promissory notes<sup>[13]</sup> from California Bus Lines, Inc. At the time of assignment, these five promissory notes, identified and numbered as 80-53, 80-54, 80-55, 80-56, and 80-57, had a total value of ₱16,152,819.80 inclusive of interest at 14% per annum.

SIHI subsequently sent a demand letter dated December 13, 1983,<sup>[14]</sup> to CBLI requiring CBLI to remit the payments due on the five promissory notes directly to it. CBLI replied informing SIHI of Civil Case No. 0023-P and of the fact that Delta had taken over its management and operations.<sup>[15]</sup>

As regards Deltas remaining obligation to SIHI, Delta offered its available bus units, valued at ₱27,067,162.22, as payment in kind.<sup>[16]</sup> On December 29, 1983, SIHI accepted Deltas offer, and Delta transferred the ownership of its available buses to SIHI, which in turn acknowledged full payment of Deltas remaining obligation.<sup>[17]</sup> When SIHI was unable to take possession of the buses, SIHI filed a petition for recovery of possession with prayer for issuance of a writ of replevin before the RTC of Manila, Branch 6, docketed as Civil Case No. 84-23019. The Manila RTC issued a writ of replevin and SIHI was able to take possession of 17 bus units belonging to Delta. SIHI applied the proceeds from the sale of the said 17 buses amounting to ₱12,870,526.98 to Deltas outstanding obligation. Deltas obligation to SIHI was thus reduced to ₱20,061,898.97. On December 5, 1984, Branch 6 of the RTC of Manila rendered judgment in Civil Case No. 84-23019 ordering Delta to pay SIHI this amount.

Thereafter, Delta and CBLI entered into a compromise agreement on July 24, 1984,<sup>[18]</sup> in Civil Case No. 0023-P, the injunction case before the RTC of Pasay. CBLI agreed that Delta would exercise its right to extrajudicially foreclose on the chattel mortgages over the 35 bus units. The RTC of Pasay approved this compromise agreement the following day, July 25, 1984.<sup>[19]</sup> Following this, CBLI vehemently refused to pay SIHI the value of the five promissory notes, contending that the compromise agreement was in full settlement of all its obligations to Delta including its obligations under the promissory notes.

On December 26, 1984, SIHI filed a complaint, docketed as Civil Case No. 84-28505, against CBLI in the Regional Trial Court of Manila, Branch 34, to collect on the five (5) promissory notes with interest at 14% p.a. SIHI also prayed for the issuance of a writ of preliminary attachment against the properties of CBLI.<sup>[20]</sup>

On December 28, 1984, Delta filed a petition for extrajudicial foreclosure of chattel mortgages pursuant to its compromise agreement with CBLI. On January 2, 1985, Delta filed in the RTC of Pasay a motion for execution of the judgment based on the compromise agreement.<sup>[21]</sup> The RTC of Pasay granted this motion the following day.<sup>[22]</sup>

In view of Deltas petition and motion for execution per the judgment of compromise, the RTC of Manila granted in Civil Case No. 84-28505 SIHIs application for preliminary attachment on January 4, 1985.<sup>[23]</sup> Consequently, SIHI was able to attach and physically take possession of thirty-two (32) buses belonging to CBLI.<sup>[24]</sup> However, acting on CBLIs motion to quash the writ of preliminary attachment, the same court resolved on January 15, 1986,<sup>[25]</sup> to discharge the writ of preliminary attachment. SIHI assailed the discharge of the writ before the Intermediate Appellate Court (now Court of Appeals) in a petition for *certiorari* and prohibition, docketed as CA-G.R. SP No. 08378. On July 31, 1987, the Court of Appeals granted SIHIs petition in CA-GR SP No. 08378 and ruled that the writ of preliminary attachment issued by Branch 34 of the RTC Manila in Civil Case No. 84-28505 should stay.<sup>[26]</sup> The decision of the Court of Appeals attained finality on August 22, 1987.<sup>[27]</sup>

Meanwhile, pursuant to the January 3, 1985 Order of the RTC of Pasay, the sheriff of Pasay City conducted a public auction and issued a certificate of sheriffs sale to Delta on April 2, 1987, attesting to the fact that Delta bought 14 of the 35 buses for ₱3,920,000.<sup>[28]</sup> On April 7, 1987, the sheriff of Manila, by virtue of the writ of execution dated March 27, 1987, issued by Branch 6 of the RTC of Manila in Civil Case No. 84-23019, sold the same 14 buses at public auction in partial satisfaction of the judgment SIHI obtained against Delta in Civil Case No. 84-23019.

Sometime in May 1987, Civil Case No. 84-28505 was raffled to Branch 13 of the RTC of Manila in view of the retirement of the presiding judge of Branch 34. Subsequently, SIHI moved to sell the sixteen (16) buses of CBLI which had previously been attached by the sheriff in Civil Case No. 84-28505 pursuant to the January 4, 1985, Order of the RTC of Manila.<sup>[29]</sup> SIHIs motion was granted on December 16, 1987.<sup>[30]</sup> On November 29, 1988, however, SIHI filed an urgent *ex-parte* motion to amend this order claiming that through inadvertence and excusable negligence of its new counsel, it made a mistake in the list of buses in the Motion to Sell Attached Properties it had earlier filed.<sup>[31]</sup> SIHI explained that 14 of the buses listed had already been sold to Delta on April 2, 1987, by virtue of the January 3, 1985 Order of the RTC of Pasay, and that two of the buses listed had been released to third party, claimant Pilipinas Bank, by Order dated September 16, 1987<sup>[32]</sup> of Branch 13 of the RTC of Manila.

CBLI opposed SIHIs motion to allow the sale of the 16 buses. On May 3, 1989,<sup>[33]</sup> Branch 13 of the RTC of Manila denied SIHIs urgent motion to allow the sale of the 16 buses listed in its motion to amend. The trial court ruled that the best interest of the parties might be better served by denying further sales of the buses and to go direct to the trial of the case on the merits.<sup>[34]</sup>

After trial, judgment was rendered in Civil Case No. 84-28505 on June 3, 1993, discharging CBLI from liability on the five promissory notes. The trial court likewise favorably ruled on CBLIs compulsory counterclaim. The trial court directed SIHI to return the 16 buses or to pay CBLI ₱4,000,000 representing the value of the seized buses, with interest at 12% p.a. to begin from January 11, 1985, the date SIHI seized the buses, until payment is made. In ruling against SIHI, the trial court held that the restructuring agreement dated October 7, 1981, between Delta and CBLI novated the five promissory notes; hence, at the time Delta assigned the five promissory notes to SIHI, the notes were already merged in the restructuring agreement and cannot be enforced against CBLI.

SIHI appealed the decision to the Court of Appeals. The case was docketed as CA-G.R. CV No. 52667. On April 17, 2001, the Court of Appeals decided CA-G.R. CV No. 52667 in this manner:

WHEREFORE, based on the foregoing premises and finding the appeal to be meritorious, We find defendant-appellee CBLI liable for the value of the five (5) promissory notes subject of the complaint *a quo* less the proceeds from the attached sixteen (16) buses. The award of attorneys fees and costs is eliminated. The appealed decision is hereby REVERSED. No costs.

SO ORDERED.<sup>[35]</sup>

Hence, this appeal where CBLI contends that

- I. THE COURT OF APPEALS ERRED IN DECLARING THAT THE RESTRUCTURING AGREEMENT BETWEEN DELTA AND THE PETITIONER DID NOT SUBSTANTIALLY NOVATE THE TERMS OF THE FIVE PROMISSORY NOTES.
- II. THE COURT OF APPEALS ERRED IN HOLDING THAT THE COMPROMISE AGREEMENT BETWEEN DELTA AND THE PETITIONER IN THE PASAY CITY CASE DID NOT SUPERSEDE AND DISCHARGE THE PROMISSORY NOTES.
- III. THE COURT OF APPEALS ERRED IN UPHOLDING THE CONTINUING VALIDITY OF THE PRELIMINARY ATTACHMENT AND EXONERATING THE RESPONDENT OF MALEFACTIONS IN PRESERVING AND ASSERTING ITS RIGHTS THEREUNDER.<sup>[36]</sup>

Essentially, the issues are (1) whether the Restructuring Agreement dated October 7, 1981, between petitioner CBLI and Delta Motors, Corp. novated the five promissory notes Delta Motors, Corp. assigned to respondent SIHI, and (2) whether the compromise agreement in Civil Case No. 0023-P superseded and/or discharged the subject five promissory notes. The issues being interrelated, they shall be jointly discussed.

CBLI first contends that the Restructuring Agreement did not merely change the incidental elements of the obligation under all sixteen (16) promissory notes, but it also increased the obligations of CBLI with the addition of new obligations that were incompatible with the old obligations in the said notes.<sup>[37]</sup> CBLI adds that even if the restructuring agreement did not totally extinguish the obligations under the sixteen (16) promissory notes, the July 24, 1984, compromise agreement executed in Civil Case No. 0023-P did.<sup>[38]</sup> CBLI cites paragraph 5 of the compromise agreement which states that the agreement between it and CBLI was in full and final settlement, adjudication and termination of all their rights and obligations as of the date of (the) agreement, and of the issues in (the) case. According to CBLI, inasmuch as the five promissory notes were subject matters of the Civil Case No. 0023-P, the decision approving the compromise agreement operated as *res judicata* in the present case.<sup>[39]</sup>

Novation has been defined as the extinguishment of an obligation by the substitution or change of the obligation by a subsequent one which terminates the first, either by changing the object or principal conditions, or by substituting the person of the debtor, or subrogating a third person in the rights of the creditor.<sup>[40]</sup>

Novation, in its broad concept, may either be extinctive or modificatory.<sup>[41]</sup> It is extinctive when an old obligation is terminated by the creation of a new obligation that takes the place of the former; it is merely modificatory when the old obligation subsists to the extent it remains compatible with the amendatory agreement.<sup>[42]</sup> An extinctive novation results either by changing the object or principal conditions (objective or real), or by substituting the person of the debtor or subrogating a third person in the rights of the creditor (subjective or personal).<sup>[43]</sup> Novation has two functions: one to extinguish an existing obligation, the other to substitute a new one in its place.<sup>[44]</sup> For novation to take place, four essential requisites have to be met, namely, (1) a previous valid obligation; (2) an agreement of all parties concerned to a new contract; (3) the extinguishment of the old obligation; and (4) the birth of a valid new obligation.<sup>[45]</sup>

Novation is never presumed,<sup>[46]</sup> and the *animus novandi*, whether totally or partially, must appear by express agreement of the parties, or by their acts that are too clear and unequivocal to be mistaken.<sup>[47]</sup>

The extinguishment of the old obligation by the new one is a necessary element of novation which may be effected either expressly or impliedly.<sup>[48]</sup> The term "expressly" means that the contracting parties incontrovertibly disclose that their object in executing the new contract is to extinguish the old one.<sup>[49]</sup> Upon the other hand, no specific form is required for an implied novation, and all that is prescribed by law would be an incompatibility between the two contracts.<sup>[50]</sup> While there is really no hard and fast rule to determine what might constitute to be a sufficient change that can bring about novation, the touchstone for contrariety, however, would be an irreconcilable incompatibility between the old and the new obligations.

There are two ways which could indicate, in fine, the presence of novation and thereby produce the effect of extinguishing an obligation by another which substitutes the same. The *first* is when novation has been explicitly stated and declared in unequivocal terms. The *second* is when the old and the new obligations are incompatible on every point. The test of incompatibility is whether the two obligations can stand together, each one having its independent existence.<sup>[51]</sup> If they cannot, they are incompatible and the latter obligation novates the first.<sup>[52]</sup> Corollarily, changes that breed incompatibility must be essential in nature and not merely accidental. The incompatibility must take place in any of the essential elements of the obligation, such as its object, cause or principal conditions thereof; otherwise, the change would be merely modificatory in nature and insufficient to extinguish the original obligation.<sup>[53]</sup>

The necessity to prove the foregoing by clear and convincing evidence is accentuated where the obligation of the debtor invoking the defense of novation has already matured.<sup>[54]</sup>

With respect to obligations to pay a sum of money, this Court has consistently applied the well-settled rule that the obligation is not novated by an instrument that expressly recognizes the old, changes only the terms of payment, and adds other obligations not incompatible with the old ones, or where the new contract merely supplements the old one.<sup>[55]</sup>

In *Inchausti & Co. v. Yulo*<sup>[56]</sup> this Court held that an obligation to pay a sum of money is not novated in a new instrument wherein the old is ratified, by changing only the term of payment and adding other obligations not incompatible with the old one. In *Tible v. Aquino*<sup>[57]</sup> and *Pascual v. Lacsamana*<sup>[58]</sup> this Court declared that it is well settled that a mere extension of payment and the addition of another obligation not incompatible with the old one is not a novation thereof.

In this case, the attendant facts do not make out a case of novation. The restructuring agreement between Delta and CBLI executed on October 7, 1981, shows that the parties did not expressly stipulate that the restructuring agreement novated the promissory notes. Absent an unequivocal declaration of extinguishment of the pre-existing obligation, only a showing of complete incompatibility between the old and the new obligation would sustain a finding of novation by implication.<sup>[59]</sup> However, our review of its terms yields no incompatibility between the promissory notes and the restructuring agreement.

The five promissory notes, which Delta assigned to SIHI on September 13, 1983, contained the following common stipulations:

1. They were payable in 60 monthly instal